

**THE ANALYSIS OF CREDIT POLICY DEVELOPMENT IN BANK AAA  
(CASE OF IMPLEMENTATION NEW POLICY ARCHITECTURE)**

Murti Kusuma Dewi and Achmad Herlanto Anggono  
School of Business and Management  
Institut Teknologi Bandung, Indonesia  
murti@sbm-itb.ac.id

*Abstract-Bank AAA as one of the largest and oldest private bank in Indonesia. Based on audit findings form Bank Indonesia, it stated that there are inconsistencies in credit policies between one credit policy to other credit policies. This leads to the NPL to be faced by the Bank, which in turn makes banks set large allowance as well. This of course will affect the capital requirements that must be owned by the Bank. Moreover, it causes different perceptions of credit policy that make the process in credit activities become not standard. This inconsistencies also leads to create different perception in doing credit activity process and credit policies. To resolve those two problems, author proposes and idea in credit policy development in a framework of credit policy development that contains of three big phase, pre-development, development and pre-development phase. Author is responsible in implementing the framework with three phases. The purpose of the framework is to have an integrated and structured credit policy. To minimize this, Bank Indonesia issued a new policy relating to capital adequacy is calculated based on the risk profile of each bank. Based on this, the bank that has large bad debt will automatically have the potential for credit risk and the greater the loss. In line with this, Bank AAA applies new policy architecture in bank-wide basis, where all existing policies have to be reconstructing especially in terms of content. With the implementation of the new policy is expected to help the parties who involve in lending activities and will ultimately reduce the amount of bad debt held by the Bank. The next step should be done by the Bank after having a policy is the attestation and monitoring of compliance in carrying out the things that are listed in the credit policy.*

*Keywords: Risk Management, Credit Policy, Policy Architecture*

**1. Introduction**

Bank AAA is the fourth oldest bank in Indonesia, established on April 4, 1941 in Bandung. Bank AAA has since evolved into a solid and reliable bank, catering mainly to the small and medium enterprise segment. It officially became a commercial bank in 1967, a licensed foreign exchange bank in 1990, and a publicly listed bank on the Indonesian Stock Exchange in 1994.

Bank AAA's well-known reputation in the market and its promising growth had merited attention from various international institutions. International Finance Corporation (IFC), part of the World Bank Group, became a shareholder in 2001 – 2010. Meanwhile, in 2001 the Netherlands Development Finance Company (FMO) provided long-term loans amounting USD 15 million with attractive interest rate to be distributed to Small and Medium Enterprise (SME) segment. Later, A Bank-Singapore, become a shareholder in the Bank and ultimately became a controlling shareholder of Bank AAA through acquisitions and tender offer since 2004. A Bank-Singapore currently owns 85.1% stake in Bank AAA.

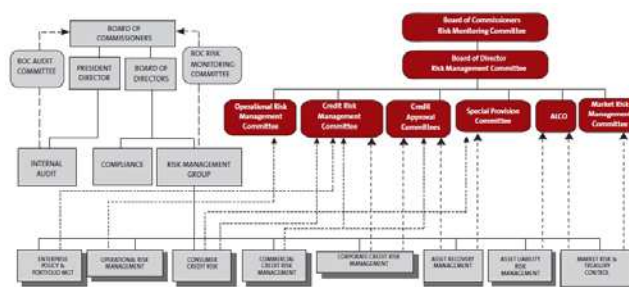
With the support from A Bank-Singapore, Bank AAA has set dynamic programs to enhance its infrastructure, including human resources, information technology and branch network. This program partly compelled the relocation of the head office to AAA Tower in the center of Jakarta in 2006, which allows direct access to the heart of businesses in Indonesia. As part of its long-term strategies,

Bank AAA adopted its new name “AAA” since end of 2008, followed by a major transformation throughout the organization. This transformation has been carried out well in the spirit to become “Your Partner for Life” to all stakeholders.

In 2011, Bank AAA celebrated its 70 anniversary with an important milestone, as Bank A Indonesia officially merged with Bank AAA. The merger is testimony of Bank A Singapore’s full commitment as the majority shareholder, to focus its support on only one bank in Indonesia, namely Bank AAA. Major composition profile of the ultimate shareholder is hold by A Overseas Investment Pte. Ltd.(OOI) more than 85%.

Today, Bank AAA has 6,498 employees who are highly motivated to serve customers in 350 offices in 62 cities throughout Indonesia. To manage different types of inherent risks in accordance with the complexity of the business, there are several dedicated work units within the organizational structure of the Risk Management Group that are responsible for handling credit risk, market risk, liquidity risk, operational risk and other risks (legal, strategic, compliance, and reputation risks). Based on the Bank’s risk management main principles, risk management process is a shared responsibility of all employees and risk awareness is already an integral part of the Bank’s culture.

Enterprise Policy and Portfolio Management Division is responsible for the sufficiency of policies, procedures, and limits, include the development of bank-wide policy architecture, as well as developing enterprise portfolio management and risk profile evaluation system that are more suitable to the business condition and characteristic of the Bank, with due consideration to current regulations on risk management.



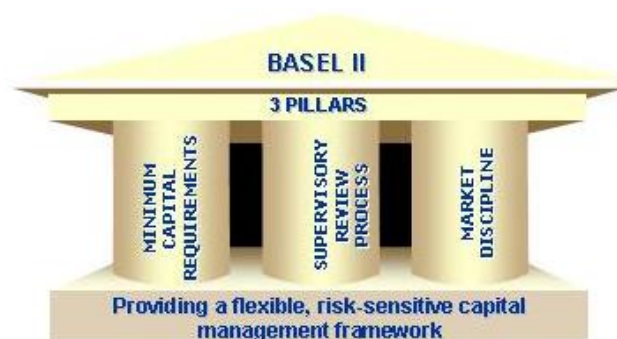
Based on the result of BI audit in 2011 especially for Credit for adequacy of Policy, Procedures and setting Risk Management Limits, there are findings that related to credit policy. BI stated that the weakness in the credit policy lies in the lack of consistency between the regulations related to each other. Furthermore, the findings are also related with credit process and documentation like temporary renewal process, short review process, appraisal process, etc. The follow-up of this issue is by implementing New Policy and Procedure Architecture to standardize all activities in granting credit.

## 2. Business Issue Exploration

### A. Conceptual Framework

A bank provides an intermediation function for funds received from customers. Failure of a bank will result in widespread impact affecting retail and institutional customers who hold funds at the bank. The importance of the banking role demands proper regulation, in which the primary objective is to maintain customer confidence in the banking system. An essential part of the regulatory framework for the banking system involves the regulations governing bank capital, which functions as a buffer against losses.

The Basel II Framework is based on a forward-looking approach that enables improvements and changes to be made over time. In this way, the Basel II framework (see figure 2.1.) is able to keep pace with changes in the marketplace and developments in risk management.



Basel II calculates the capital requirement according to the bank risk profile and contains incentives for improvement in risk management within the banking system. By using various approaches to measure credit risk, market risk and operational risk, the result obtained is more risk-sensitive allocation of bank capital. In Basel II, the calculation of bank capital is prescribed in Pillar 1—the Minimum Capital Requirement.

In assessing bank capital adequacy, it is not only necessary to allocate capital on the basis of Pillar 1, but also capital to anticipate losses from other risks, such as liquidity risk, strategic risk, interest rate risk in the banking book and other risks. This approach is captured in Pillar 2, the Supervisory Review Process, and is referred to as the Individual Capital Adequacy Assessment Process (ICAAP).

Pillar 3 requires banks to disclose adequate information for market players to understand the risks involved in the banks. This enables market players to assess the key information on the scope of risk, capital, risk exposures, risk measurement process and bank capital adequacy. Align with Basel II Accord Framework implementation in Indonesia where it stresses explicitly that capital is only one aspect of prudential standards and regulations, Bank Indonesia imposed regulations on the calculation of minimum capital in accordance with the bank's risk profile. This is reflected in Bank Indonesia Regulation No. 14/18/PBI/2012 dated 28 November 2012 regarding Minimum Capital Adequacy Requirement for Commercial Banks and Bank Indonesia Circular Letter No. 14/37/DPNP dated 27 December 2012 regarding Minimum Capital Requirement Based on Risk Profile and Fulfillment of Capital Equivalency Maintained Assets (CEMA).

Bank AAA conducts ICAAP (Internal Capital Adequacy Assessment Process) to comply with this regulation. ICAAP is a process conducted by the Bank to stipulate capital adequacy in accordance with the Bank risk profile and the determination of the strategy to maintain funds level. Bank AAA performs on-going analysis on capital adequacy position by benchmarking against the minimum capital ratio required by banking regulators, which serves as the industry standard for measuring banking capital adequacy. Measurement of total bank capital is most commonly referred as Capital Adequacy Ratio (CAR).

(Dalam Miliar Rupiah)						(In Billion Rupiah)
Keterangan	2012	2011	2010	2009	2008	Description
Modal						Capital
Modal Tier 1	8,336	6,029	5,489	4,603	4,279	Tier 1 Capital
Modal Tier 2	1,537	1,498	1,387	1,007	1,191	Tier 2 Capital
Penyerahan Saham	-	-	-	-	-72	Investment in Shares
Total Modal	9,873	7,527	6,876	5,610	5,397	Total Capital
Aset Tertimbang Menurut Risiko						Risk Weighted Assets with Capital Adequacy Ratio
Risiko Kredit	54,773	49,782	34,890	26,878	21,998	Credit Risk
Risiko Kredit dan Pasar	55,167	50,210	36,312	27,425	28,478	Credit and Market Risk
Risiko Kredit, Pasar dan Operasional	59,885	54,745	39,015	-	-	Credit Risk, Market Risk and Operational Risk
Rasio Kecukupan Modal Memperhitungkan:						Capital Adequacy Ratio including:
Risiko Kredit	18.0%	15.1%	19.7%	20.9%	19.3%	Credit Risk
Risiko Kredit dan Pasar	17.9%	15.0%	18.9%	20.5%	19.0%	Credit and Market Risk
Risiko Kredit, Pasar dan Operasional	16.5%	13.8%	17.6%	-	-	Credit Risk, Market Risk and Operational Risk

Credit risk is the biggest risk in the Indonesian banking system and can be a major cause for the failure of the bank. In the context of credit risk, inherent risk (credit risk inherent) is defined as the risk inherent in the portfolio of assets without considering the adequacy of risk management or credit risk

control system. The Credit Risk Management System (Risk Control System / RCS) is defined as a series of systems of the bank in order to control or minimize the negative impact of the credit risk of the Bank's financial condition and performance. Bank AAA implementing this new regulation using the risk profile rating at the position on December 2012. Bank's making some adjustment to comply with the regulations, which are changes in risk parameter and threshold.

No	Risk Type	Remarks
1	Credit	<ul style="list-style-type: none"> <li>Add new Inherent Risk Parameter</li> <li>Change Inherent Risk Parameter</li> <li>Change Inherent Risk Threshold</li> <li>Add weighting</li> </ul>
2	Market	<ul style="list-style-type: none"> <li>Add weighting</li> </ul>
4	Operational	<ul style="list-style-type: none"> <li>Add new Inherent Risk Parameter</li> <li>Re-classfy Inherent Risk Parameters</li> <li>Change Inherent Risk Threshold</li> <li>New Implementation Quality Parameter</li> <li>Change weighting</li> </ul>

In Risk Profile Rating – Credit Risk, from table below it stated that inherent risk rating is low but there is an adjustment because of this new regulation and final inherent risk rating is Low to Moderate. The quality of risk management implementation rating for credit risk is satisfactory, and it leads to Low to Moderate rating in composite credit risk profile.

Credit Risk - Comparison of Risk Profile Rating Q1-2013

	Old		New	
Inherent Risk Rating	1.13	Low	1.11	Low
Adjustment	No		Yes – there are some findings in credit process (lack of monitoring in EmB portfolio and Consumer – auto loan)	
Final Inherent Risk Rating	Low (1)		Low to Moderate (2)	
Quality of Risk Management Implementation Rating	2	Satisfactory	2	Satisfactory
Composite Credit Risk Profile Rating	Low		Low to Moderate	

One of the reasons why the inherent risk and composite risk drops to low to moderate is there are changes in the parameters and threshold. In the next table, one of the changes in parameter and threshold is total loan to total assets. The Bank decides that the reasonable limit of total credit is 65% - 75% from total assets. The Board manages Bank AAA's business activities prudently throughout 2012. This is reflected in the Bank's performance, which remains consistent to the business plan amid tight competition in the national banking sector, and supported by effective risk management, good corporate governance (GCG) implementation and transparency of information.

Bank AAA recorded total assets of Rp 79,142 billion, growing by 32.3% compared to Rp 59,834 billion at the end of 2011. This achievement also reinforces Bank AAA's positioning as the seventh largest national private bank in terms of total assets with market share of 1.8%. The growth in total assets was primarily supported by growth of gross loans by 28.2% from 2011, which was also supported by growth of third party funds by 28.1%. Loan to Deposit Ratio (LDR) stood at 86.8% at year-end 2012 in comparison to 87.0% at the end of 2011, which was considerably higher to industry-wide LDR of approximately 83.6% at the end of 2012.

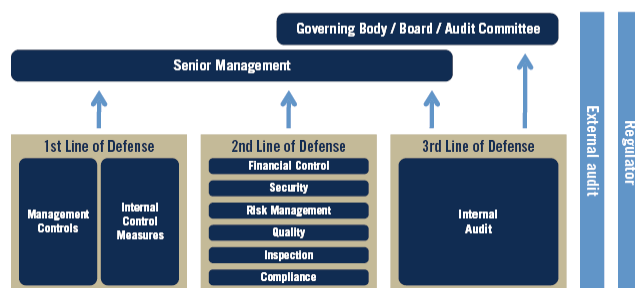
With overall consistency, Bank AAA maintains asset quality, as reflected in the reduction of Net Non Performing Loans (NPL) to 0.4% of total net loans or the equivalent of Rp 193 billion as of December 31, 2012 in comparison to the year-end 2011 position of 0.6% or a total amount of Rp 242 billion. Hence, the Bank's net NPL remains significantly lower relative to the industry average of approximately 1.9% in 2012 and substantially below Bank Indonesia's prescribed rate of 5.0%.

If the bank is not careful in giving loan to debtor, then the bank will potentially face credit risk in the form of non performing loan. If non performing loan owned by bank is big, then the bank must reserve some funds to cover losses and it will also affect the bank's capital. As stated before, one of the key elements in RCS parameter is sufficiency of policies, procedures and limit. Next chapter will describe about new policy architecture that will help business unit as guidance in giving loan and in the end will minimize non performing loan.

Bank AAA has allocated adequate amount of allowance for impairment losses to cover potential losses that may arise from non-performing loans, as reflected in the higher ratio of loan loss provision to NPL at 214.1% on December 31, 2012 compared to only 141.5% as of December 31, 2011.

Based on the Bank's risk management main principles, risk management process is a shared responsibility of all employees and risk awareness is already an integral part of the Bank's culture. With Three Lines of Defense approach, risk management functions are conducted comprehensively throughout all levels within the organization, which is initiated at the top by oversight functions of the Board of Commissioners and Board of Directors.

#### The Three Lines of Defense Model



Top management, frontline businesses, and all supporting units collectively serve as the First Line of Defense in their pursuit of business growth, with balanced consideration of risk factors in every decisions made. At the Second Line of Defense are Risk Management Division and Compliance Division in charge of managing risks independently, together with the Bank's Internal Audit Division as the Third Line of Defense responsible for providing risk assurance as well as monitoring and periodic evaluation.

The first line of defense held by the unit or component or function of the business activities of Bank AAA operational day-to-day, especially the front line which is spearheading the organization. In this case, the role of First Line is to:

1. Understanding customers' needs by considering aspects of risk and internal control
2. Understanding the risks and ensure there are adequate internal controls for these risks
3. Identifying and control risks and to ensure that significant risks are reported to the Board of Director in accordance with the existing risk monitoring committees.
4. Implement risk management policies that have been set, especially as related to risks in pursuing of business growth. Wherever possible the decision was taken by considering risk.

Second line of defense functions conducted by risk management and compliance, in this case by the Group Risk Management and Compliance Group, which involved in:

1. Set the internal regulations regarding risk management, financial and non-financial.
2. Measuring, monitoring, analyzing and reporting of risks to the Board of Director and the risk monitoring committees that responsible for developing and monitoring of the implementation of risk corporate governance as a whole.
3. Performing monitoring toward how the business functions performed in the corridor of risk management policies and standard operating procedures that have been set by Bank AAA.

Third line of defense used by the auditor both internal auditor Bank AAA and external auditors. Internal Audit Unit at Bank AAA is the function that is independent and reports directly to the President Director. The role of the Internal Auditor is to:

1. Conduct periodic review and evaluation of the overall risk governance in Bank AAA.
2. Give recommendations on the risk governance in Bank AAA based on their evaluation.
3. Ensuring that the First and Second Line of Defense run as their respective roles.

To strengthen its risk management function, since mid-2011 Bank's Risk Management Group has initiated the implementation of the New Horizon Strategy, consisting of three phases: Phase 1 – Build Foundation and Framework, Phase 2 – Establish Depth and Distance, and Phase 3 – Crafting Synergies for the Future. The 3 phases of Risk Management Group's New Horizons Strategy will be evaluated, developed, and refined on an ongoing basis to maintain consistency with developments in the Bank's organization and business complexity with due regard to Bank's business plans in the future.



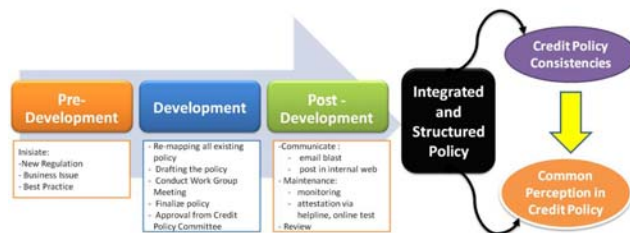
In order to further improve risk planning and supervision, the development of the Bank's risk management emphasizes on 4 (four) pillars of risk infrastructures. The infrastructures built by Risk Management Group are intended to be able to holistically accommodate the risk management framework of the Bank. These four pillars are organization, policy, system and data, and methodology. The second pillar of risk infrastructure is focuses on the development of risk policies and frameworks. The policy development process is regulated in the form of more structured policy and procedural architectures. These architectures comprise of 5 (five) levels, where the first level, or the Risk Management Policy, becomes the guidance for all implemented policies and procedures of the Bank. To the extent that risk implementation and management are ingrained into the commitment and paradigm of management and every employee of the Bank. From Bank Indonesia Audit Findings in 2011, it was clear that the Bank have the lack of consistencies in credit related policies. Bank's commit to reconstruct all credit related with implementing new architecture of policies and procedures.

### 3. Business Solution

In solving business issues that face by the Bank, author proposed Framework of Credit Policy Development as business solution. Enterprise Policy and Portfolio Management (EPPM) Division take lead and responsible as policy initiator and owner of credit policies. There are three big steps in developing policy that consist of Pre-Development, Development and Post Development. These steps shall be implemented in purpose to have an integrated and structured credit policy. As result, the new credit policy will be consistent between one policy and others; and in the end will make common perception in credit policy.



## Framework of Credit Policy Development



EPPM Division as policy initiator creates a new credit policy. Sources in create a new credit policy can be obtained from:

1. New regulations by regulators (Bank Indonesia or Government); and/or
2. Business Issue that Bank's faced; and/or
3. Best practice in banking industry.

Policy initiator collects data from resources above. Currently, the Bank has a lot of credit policies, but it scattered and overlaps each other. A new credit policy can be create from existing credit policies and merge into one credit policy. For example, in making one credit policy, policy initiator need to collect from more than fifteen credit policies includes procedures, credit product program guidelines, internal memos, management decrees, etc. Improvement that needs to be implemented in collecting data is in order to align with Bank's group credit policies. Bank's group is enforcing the Bank to adopt group policies and align with them, except for regulation that come from regulator (Bank Indonesia) then the Bank is allow to localize the policy.

Based on the initiatives, EPPM Division starts to develop the draft of the policy in development step. Source of draft policy can be from existing policies that need to be re-mapping. For example, in create and develop one credit policy it needs to collect more than fifteen of existing credit policies and do the re-mapping.

Once the draft finish, EPPM Division conduct meeting in work group to discuss detail content of the policy. One work group is dedicated for one credit policy, where it contains of Business Unit function and Support Units function (Legal, Compliance, Credit Administration, Credit Operation, Appraisal, Remedial, etc). Membership of a work group can consist of same working units, especially the support function. But for business unit is depends on what credit policy that need to be develop, because all new proposed credit policies are based on type of credit business (Corporate, Commercial, Consumer, Emerging Business).

This work group is strongly needed to make the policy consistent between other policies and to eliminate different perception within related working units. After certain work group meetings, EPPM Division finalizes the draft policy and requires approval. Once all the credit policy is made and approved, the last step to do is post-development phase. In post-development, it describes how the credit policies are communicating and monitor the implementation by EPPM Division as policy initiator and policy owner. EPPM Division communicates the new credit policy via email notification or email blast to the relevant parties (business unit and support function units), notification in internal web, conduct workshops and as facilitator in credit trainings. Moreover, the policy owner also serves as a call center if there is a question of the parties in the field of credit process. The feedback from business unit and support units while processing a credit are valuable in reviewing and develop the policy.

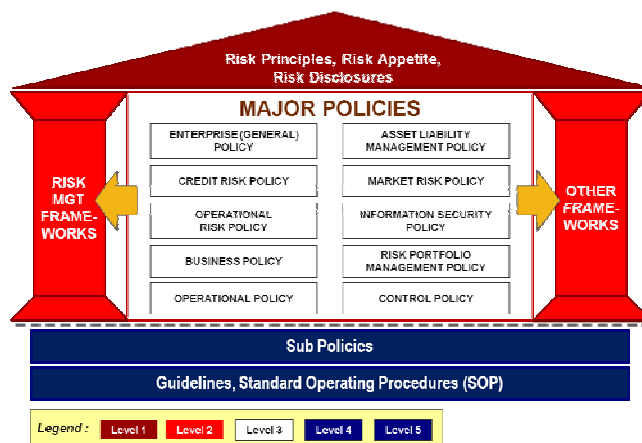
Implementation of this policy is also continuously monitored by seeing how many exceptions or deviations during the credit process. This occurs due to the business dynamic but the policy felt unsupported with the business growth, so that deviations can be input for the policy owner at the time of the annual credit policy review. The purpose of this policy monitoring is to be aware of things

that are often distorted, so it can be strictly regulated and mitigate the risks also to minimize credit risk that would arise in the future but in the other hand the business will continue to grow. Another step that will be done is to conduct online credit questionnaire. The purpose is to test the ability of the relationship managers in know and understanding of credit policies. This online test is done on a regular basis and will be one aspect of the annual appraisal.

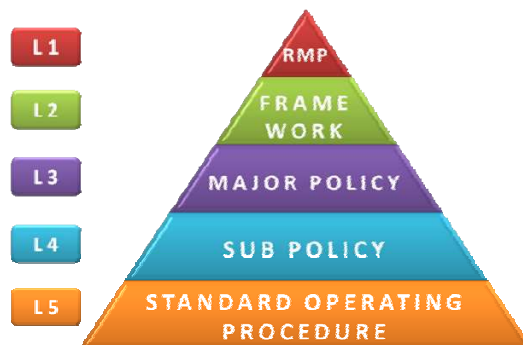
Implement policies and procedures by creating structures and policies that tiered architecture as best practice and regulation of Bank Indonesia. It is intended that the application of risk can be more structured starting from the portfolio level down to the transactional level. Policies and procedures architecture consists of five levels, which is the highest level of risk management policies and guidelines which became the umbrella for all policies and procedures applicable in the Bank. It is expected that the application of risk management will become commitment and foundation of thinking and acting of management and all employees of the Bank.

Stipulation of infrastructure policies and procedures related to the strategy and the Bank's Board of Directors and management including how to establish acceptable levels of Bank risk appetite in achieving its objectives. It has become an essential part of risk management guidelines in Bank AAA so it can be adjusted to the desired risk profile. Policies and Procedures Structure are adopted by the Bank AAA as follows:

1. Level 1: Risk Management Policy
2. Level 2: Risk Management Framework and other Frameworks
3. Level 3: Major Policies
4. Level 4: Sub-Policies
5. Level 5: Guidelines and Standard Operating Procedures



To simplify the architecture, author adopts the policy architecture to become policy pyramid as shown in figure below.



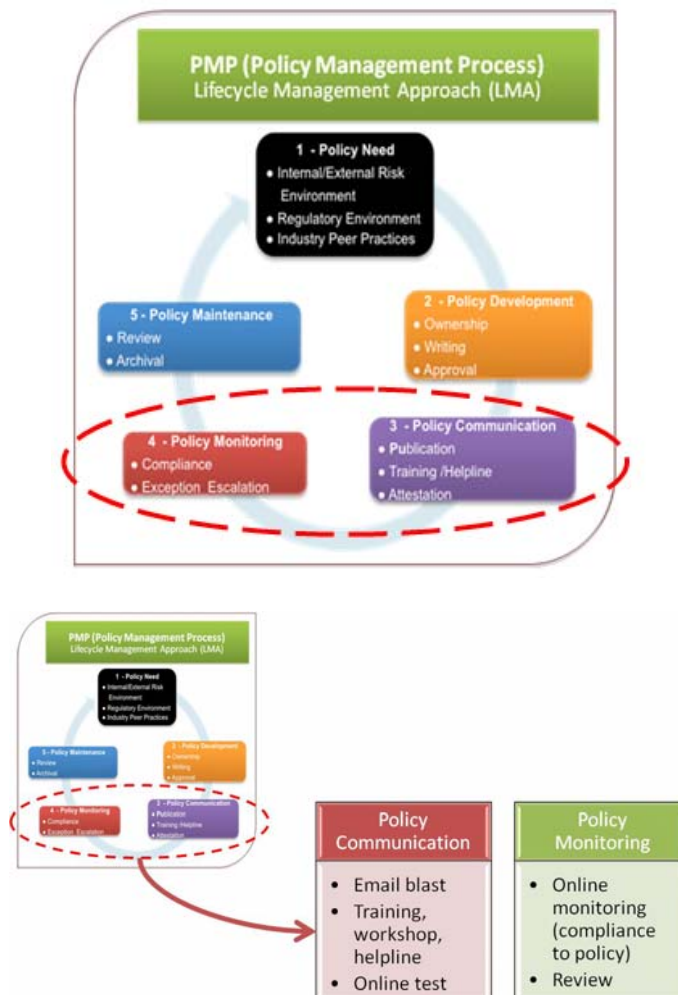


By implementing policy pyramid, the new credit policy will become integrated and structured. Integrated means that the new credit policy regulates end-to-end process in credit activities in one policy for one specific business segments and structured means that there are no more overlaps between credit policies that will cause inconsistencies.

In order to have the same perception on new credit policy, it is necessary to improve the credit policy development framework. Author proposes to use Policy Management Lifecycle. The purpose of apply this lifecycle is to make the policy become more effective. The Bank adopts the policy management lifecycle and elaborates it into Policy Management Process. This loop will run continuously in developing the credit policies.

Based on the policy management process lifecycle above, the Bank already implements all five stages, but not entire stages are proper. There are only three stages that in author opinion are proper, which are policy need, policy development and policy maintenance. For policy communication and policy monitoring is not properly done by the Bank. The Bank only does communication via email blast and places it in internal web, and rarely conducts training. When the related parties are not well inform about the new credit policies, they are not complies and it will leads to many exceptions and escalation. This is needs to be monitored closely by the policy owner.

Author proposes to make improvements in this lifecycle, especially in Policy Communication and Policy Monitoring.



Once the new credit policy is approved, it is need to be communicating to all related parties and closely monitor as part of post-development phase. Type of communication that can be done is by send electronic mail to related parties and post into internal web. Moreover, conduct training or workshop or become speaker in ad hoc basis also become part of policy communication. To ensure that all related parties know and read the policy, author also proposes to launch credit online test. In policy monitoring, author proposes to develop an integrated policy monitoring. This online monitoring will help policy initiator in review the credit policy that will be conducted annually.

The conclusions based on the business issues are:

1. To eliminate inconsistencies between one credit policies to other credit policies, author compile all existing credit polices and reconstruct into a new format of credit policy that integrated and more structured. In developing new credit policy, it is need to be discussing among related parties in a specific work group to ensure that there is no different perception on the policy.
2. To resolve different perception in the implementation in credit processing, the Bank shall applying the policy development process properly. In development stage, there is work group meeting that contains all credit related parties (business function and support units function) to discuss draft policy before it finalize and get approval. After the credit policies are approved, the Bank does the policy communication. By doing these, it helps all credit related parties to have same understanding on the new credit policies.

The author strongly recommends the Bank to continuously implementing the policy development framework and policy management process lifecycle properly. By applying these, it will help the Bank to have an integrated and structured policy. With integrated and structured policy, all credit related parties shall have the same perception and standards while doing credit process. In the end, the Bank will have a good quality of credit and can minimizing the potential credit risk and losses.

Applying the new architecture of policies and procedures, followed by the policy management process will help the Bank to have a structured policies and procedures and will facilitate all lending related parties to have a same perception on lending activities. In the end, the Bank will have a good quality of credit and can minimizing the potential credit risk and losses.

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